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INFO RUCNCLS/ALL SOUTH AND CENTRAL ASIA COLLECTIVE
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RUEHBJ/AMEMBASSY BEIJING 2356
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RUEKJCS/JOINT STAFF WASHDC
RUEHGV/USMISSION GENEVA 0778
RUEHVEN/USMISSION USOSCE 2762
RUCNDT/USMISSION USUN NEW YORK 2144
RUEHNO/USMISSION USNATO BRUSSELS BE
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SUBJECT: ELECTION EVE ECONOMIC CONDITIONS IN KYRGYZSTAN

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11. (SBU) Summary: Amidst the political wrangling preceding the December 16 Kyrgyz parliamentary elections, there have been significant economic and financial developments in the Kyrgyz Republic during the past year. Despite strong economic growth in 2007, increasing inflation and the falling value of the U.S. dollar have hurt voters' pocketbooks. With the Kazakh credit crunch forcing local Kazakh-backed banks to curtail lending, the Kyrgyz central bank is contemplating injecting more of its nearly \$1 billion in U.S. dollar reserves to sustain banking sector liquidity. At the same time, however, the central bank is concerned about contributing to a further erosion of the U.S. dollar exchange rate, as many Kyrgyz keep their savings in dollars, but supporting the dollar rate by intervening in the foreign exchange market could prove inflationary. Days to go before the scheduled vote, President Bakiyev has announced salary hikes of up to 30% for many public sector employees amidst an inflationary environment. A recent opinion poll revealed that households listed the improvement of living standards as their main objective and cited inflation as the government's biggest collective mistake, but it is not clear to what extent pocketbook issues will affect the outcome on election day. End summary.

Overview of Economic Conditions

12. (U) With the December 16 parliamentary elections around the corner, political rhetoric has largely drowned out any discussion of the personal financial issues affecting the Kyrgyz electorate. Although Kyrgyz gross domestic product has expanded by roughly 7-8% in 2007, largely due to cross-border trade and construction activity, inflation estimated at 20% combined with much higher price rises for various staple food items has pinched many pockets. The annual inflow of remittances into the Kyrgyz Republic, which a World Bank report estimates will total about \$739 million

this year, continues to raise living standards, but at the price of higher inflation and increased economic and financial uncertainty.

Impact of Dollar Weakness and the Credit Crunch

13. (SBU) The Kyrgyz Central Bank has amassed dollar reserves, currently estimated at nearly \$1 billion, partially as a result of repeated interventions to temper the rapid appreciation of the Kyrgyz som. Nevertheless, the dollar has slid 9.4% against the som this year. With significant private savings held in dollars, the Bank has attempted to prevent a massive loss of wealth among Kyrgyz citizens. Given the limited development of investment vehicles in the Kyrgyz Republic, individuals hesitant to hold dollars continue to plow money into dollar-denominated real estate, which in turn generates downward pressure on the dollar exchange rate.

14. (SBU) The global credit contraction, and the pressure on banks in neighboring Kazakhstan to repay international loans, has had a mixed impact in the Kyrgyz Republic. Many Kazakh-backed banks in the Kyrgyz Republic have significantly scaled back lending (loans are generally extended in dollars), causing one banking executive to surmise to the Embassy that "there is no money (credit) available." Another industry observer cautioned Embassy that the Central Bank governor and President Bakiyev's main economic advisor are both worried about Kazakh banking sector developments, especially as Kyrgyz banks are starting to build up excess reserves and the Central Bank may be forced to inject liquidity (in the form of dollars) to replace funds leached from Kazakh-backed Kyrgyz banks to repay syndicated dollar-denominated loans in Kazakhstan.

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15. (U) Despite these credit difficulties, some Kyrgyz banks remain active in trade-related finance activities. Plus, construction in some areas continues while financing for other projects has disappeared, leaving some building sites devoid of activity. However, private holdings of dollars are still being redirected to real estate, with new apartment prices in Bishkek increasing 17.8% since January 2007 to \$1,060 per square meter.

Keeping Promises and Withholding Bad News

16. (SBU) Surging customs and tax revenues have generated Kyrgyz budgetary surpluses. While the government has moved to reduce taxes on certain food items in response to price inflation, large sums from the state budget are now being used by the restart of construction at the Kambarata 2 hydroelectric station. In early December, President Bakiyev issued a decree authorizing up to 30% salary increases for public sector workers effective January 1, 2008. Some local government employees are being offered even larger increases.

While these measures may raise standards of living and reduce the temptation for corruption, the proximity to the December 16 elections is likely not coincidental.

17. (SBU) Despite these expenditures and promises of greater salaries, rumors persist of price hikes taking effect after the elections. One senior politician told the Embassy that the largest retail gasoline chain will increase prices 30% shortly after the elections. (Note: Amidst the nearly doubling of global crude oil prices this past year, premium grade gasoline sold in Bishkek has edged up only 6% over the same timeframe. End note.) Meanwhile, there has been little slackening of food and housing price inflation, and the government has discussed increasing electricity tariffs in the spring.

Comment

18. (SBU) Potential voters are reminded of the continued upward spiral in food, transport and energy prices in their daily activities. The promise of increased salaries, after the elections, will not eliminate existing price inflation and any further devaluation of the dollar. According to a recent opinion poll, households surveyed identified improving their standard of living as their most important issue and identified inflation and high prices as the government's biggest collective mistake. However, we will have to see if voters focus on economic and financial issues in their balloting on December 16.
YOVANOVITCH